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The Indirect Relation between Corporate Governance and Financial Stability

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Abstract

In the wake of last crises, there is an increased awareness regarding the role of a sound corporate governance framework for enhancing the financial stability. We believe, however, that the relationship between corporate governance and financial stability is an indirect one; companies are not obliged to pursue financial stability unless specific legislation or regulations require it. Interestingly, having such targets, large firms, especially those operating in the financial system, can lead to systemic risks, supporting financial contagion. Classical problems of corporate governance such as top management compensation, board composition, and independence of the director, agent theory or the correct valuation are problems envisaged to be analyzed when assessing how they affect financial stability.

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1. Introduction

After the financial crisis, both academics and practitioners have started to give heed to corporate governance issues, as financial stabilizer or source of instability. Some companies, especially those listed on stock exchanges, reacted at the stakeholders' restraint and decided to re-analysed and recast their principles of corporate governance,

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according attention to financial and also non-financial risks, given that different activity sectors, companies with different size, and state-owned companies or private ones may need different approaches.

Nor only financial crisis, but also other systemic threats that are not properly approached and may have large negative impacts on shareholders and stakeholders, can reflect the failure of corporate governance. If the shareholders are hit first, and usually are the first who react at bad news, the impact of awkward corporate governance is transmitted to the whole economy.

The role of multinational companies is more influential nowadays, as they are spreading around the world, homogenizing the corporate governance best practices. On the international level, institutions like Organisation for Economic Cooperation and Development and World Bank tried to promote standard rules for the principles of good corporate governance, but their understanding and implementation is different apprehended.

While the issue of good corporate governance and adequate codes came into sight quite recently, in the early nineties, the idea of a high standard for proper and quality decisions process is rather old and reappeared after every financial crisis.

In this paper we intend to unfold the relationship between corporate governance and financial stability, an indirect one in our opinion. Inasmuch as companies are not obliged to pursue financial stability unless specific legislation or regulations require it, especially companies operating in the financial system can lead to systemic risks, supporting financial contagion.

2. Financial stability from the "being of well-functioning" (as mentioned in Wymeersch, 2008) to a forthright objective

Financial stability, or more often in these latter days, financial instability is the topic of many discussions and scientific papers. Usually, financial stability is the primary objective of national banks at the national levels (before the crisis, only 2/3 of the central banks had an explicit mandate for financial stability – Caruana, 2014), and, at the international level, international regulators such as Basel Committee or international financial institution make all possible endeavours to encounter the endangering of instability.

After the crisis is installed, the list of beneficent and efficient tools the authorities may use is shortening. This is why the preventive policies are needed and valuable. The role of macro-prudential policies was increased, being created new institutions and accommodated special arrangements between central banks, governments and other agencies, taking into account the diversity of economic and political frameworks, with a special touch of cultural elements.

After the recent crisis, it is recognized that financial stability has a magnitude that cannot be neglected. A frowning impairment of the financial market may unpredictable prejudice the real economy. As evidenced in the literature, emerging markets were more prepared to strive against appeared endangering and imbalances and appreciated to approach the financial system as a whole.

As mention in the ECB (2010) document, the origins of financial instability are usually identical: "balance sheet mismatches, high leverage and very rapid growth of financial institutions". Somehow, all these elements are interlinked with corporate governance.

3. Financial stability at micro and macro levels

Financial stability is divergent from other economic goals. It is similar with a "public good" that is useful for everybody and the lack of it can harm anyone, but nobody is obliged to act in order to keep it well; every action is volunteer. Similarly, there is no imponent for firms to choose the interest of the whole economy like in the case of choosing financial stability as its objective.

While a financial stability framework can help most companies to operate in normal conditions, for others the instability can be a source of profit. Voluntary adoption is valid for corporate governance too, unless some legal restrictions apply. The firm's decision can be selfish, looking for its own interest and not the general interest, for the entire economy.

Different situations can be observed for local or multinational companies when facing the threats to financial stability.

4. The interlinking between corporate governance and financial stability

In the 2004 edition of corporate governance principles, the Organisation for Economic Cooperation and Development mentioned that corporate governance is highly important for financial stability and economic growth by ensuring credibility and reliability for investors and general stakeholders.

As mentioned in Ananchotikul and Eichengreen (2009), the quality of corporate governance is not only a reflection of financial development, but it can positively affect it.

It was observed that, in a natural way, after each period of financial distress, the corporate governance standards suffered revisions following widely accepted improvement demands addressed to features bearing peculiar concern.

Failure and weaknesses of corporate governance that contributed recently to the financial instability are linked with central elements that are at large discussed in the literature – accounting standards and remuneration systems that still encouraged the risk taking position, while compromising the long term interest of the companies. Accounting standards had played an important role, contributing to the financial instability, but their influence was rather outstanding in the financial sector. As for incentive and remuneration of top management, even if it was a widely debated issue for a long time, it was still an essential vicious aspect, unsolved at the time of crisis occurrence. This aspect augmented the financial firms' perceptivity of the negative economic shocks and affected their balance sheets' situation.

As mentioned in Kirkpatrick (2009), when analysing the failure of risk management during the financial crisis there is the case that, in many situations, the corporate governance procedures were a main contributor, though malfunctioning of different aspects like monitoring the implementation of approved strategies or disclosure of predictable risks.

Since risk management strategy is generally decided by the board of directors, its proper qualification and capacity is a basic need for a company. In literature (Kirkpatrick, 2009) mentioned that internal management did not received the needed attention, being observed inaccuracies in information output transmission from financial risk models to the board, in monitoring the management practices and strategies implementation, and withal financial reporting control.

A distinction between financial institutions and other types of companies refers to the ways in which the other stakeholders are affected by shareholders risk taking habits. The most relevant situation is the one in which financial institutions approach their default, in which case shareholders tend to endure more risk betting on their fast rehabilitation rather than a smooth and sound recovery. This situation generates the propensity of shareholders to design compensation packages for the workers to induce this type of behavior, which is at the disadvantage of creditors, since they are prone to less risk by their nature.

Another important issue in the analysis of corporate governance of financial institutions is the fact that their shareholders, managers and bondholders will have different interests and act at the disadvantage of the rest of the society by the fact that they do not encompass the systemic risk in their interests and they configure compensations packages that could be in contrast with the interests of taxpayers and other institutions in a national economy. This highlights the dichotomy between preferred levels of risk in the case of financial institutions on one hand and the financial stability on the other hand.

The International Monetary Fund (2014) report conducts an empirical analysis with this exact purpose and finds evidence at the international level that some indicators of corporate governance are dependent on risk taking actions in financial institutions. By and large their findings show four main results: a) the more independent the board of directors is with respect to the management in a financial institutions, the lower the risk it takes; b) the enforcement of risk management compliance tools is generally an enhancer of sound risk taking measures inside a financial institutions; c) large salaries are associated with high risk for small financial institutions, while equity-linked payments generally induce less risk and d) risk taking is dependent on the institutions ownership by the fact that their presence in the shareholder structure of the financial institution consists usually in a large fraction, therefore a proclivity to less risk in their actions.

Not at the last place worth to mention the involvement of other elements like rating agencies failure and regulatory aspects that promoted the interlinking between corporate governance and financial instability.

5. The need to introduce some refined element of corporate governance

After main financial crises, the need for reform appeared in many domains including improvement of financial market supervision and regulation, enhancement of macro-prudential policies, exchange rate policies, and balance sheet remediation. Between these elements, corporate governance is just a small item, but nonetheless a debatable and significant one, being an unequable development across countries and companies.

Gupta et al. (2013) summarized the results of few recent reports that concluded that “the current corporate governance system failed the test”. It is also true, that even a progress of corporate governance was registered over the last years, a common receipt is not possible for countries with different economic and financial development (Peng, 2003; Zahra and Filatotchev, 2004; Wright et al., 2005), with different legal framework and cultural features. This is combined with the possibility that the existing principles were not properly implemented and their deployment was not monitored.

The reform of corporate governance is a timely topic and the main discussed issues are advancement of regulation in this area and rectification of executive’s pay (International Monetary Fund, 2014).

One conventional issue discussed in the literature is that of agency theory concerning the problems that may arise between managers and owners of the forms (first mentioned by Jensen and Meckling in 1976). The managers are paid and monitored in order to ensure that their actions will be in the interest of shareholders and in this sense, their compensation is commonly supplemented with performance compensation schemes that obviously make them sensible to shares values. Risk management complexity in the financial sector is usually higher than in other sectors and because of this the agency issues have greater importance.

A great deal of academics as well as general opinions issued by representatives of the financial industry and the public sector in the most developed countries share the view that the recent financial crisis was rooted by the configuration of specific compensations inside financial institutions. These incentive packages are considered to have fed excessive risk taking, which generated important after crisis regulatory measures intended at limiting these propensity to invest.

Therefore, a clear understanding of the extent to which shifts in regulatory initiatives could attain their objectives rely heavily on the analysis of the connections between corporate governance and employment compensations on one hand and the achievement of a high degree of financial stability on the other hand.

The basis of this analysis relies on the fact that the standard “agency” problems that arise between shareholders and managers, have higher intensity in the case of financial institutions as opposed to other types of companies. The decisive distinction is caused by the weight and complexity of risk management in the case of financial institutions in general, since assuming the outcome of investments represents the core business of these companies. This process largely gains in difficulty by the fact that top managers are keen to delegate risk taking decisions to lower level workers and to relate compensations on their performances.

Corporate governance can bring its contribution to increase transparency, influencing the disposition to accurate disclosure, both in accountability and risk management. There is known in the literature that shareholders, and especially long-term investors, act like an warning system for a company, but to preserve this role is needed that companies be as much as possible transparent with their shareholders.

Three aspects that should be pursued by politician were mentioned by Morck and Yeung (2010) in the paper Harmonious Corporate Governance: the correctness of the financial data, the validity of disseminated information, and the possibility of shareholders to undertake adjustment measures when serious problems are detected.

In the same time, the new financial instruments and markets rapid developments supported the emergence of new classes of shareholders that are not necessarily interested in the long-term evolution of the companies. If this category of shareholders represent the majority of a company, the risk taking actions will be encouraged.

On the international level, some countries and more important international institutions like Basel Committee on Banking Supervision, Organisation for Economic Cooperation and Development, Financial Stability Board, started reform endeavours for corporate governance in the financial sector, summarized by International Monetary Fund (2014) in the Financial Stability Report (next Table).

Table 1. Some examples of reform initiatives for corporate governance.

Institution/Country	Initiative	Content
Bank for International Settlements	BCBS Principles for Enhancing Corporate Governance	Board practices Compensation Corporate structures Disclosure and transparency Risk management Senior management
Canada	Ontario Securities Commission	Board Structure
	Toronto Stock Exchange	Board Structure
European Union	CRD IV and CRR	Board of Directors Compensation
Financial Stability Board	FSB Principles and Standards for Sound Compensation Standards	Compensation
United States	Dodd-Frank Act (2010)	Board of Directors Compensation
	SEC proxy rules	Board of Directors Compensation

Source: Author's adaptation after IMF (2014)

6. Final remarks

The last economic developments reinforced the outstanding role of corporate governance for economic and financial forwardness and in general for the society's prosperity. As mentioned before, the quality of corporate governance can positively affect the financial development and stability, and when missing, can conduct to financial distress. The enforcement of corporate governance can give a long-term perspective for capital markets and would increase the participation of institutions.

Especially for financial institutions, risk taking is a usual decision, but sometimes this can surpass the economically and socially desirable levels and conduct to financial instability. Is possible that corporate governance will not solve this problem, but at least an improvement can be made.

In the wake of deficient documentation regarding the current situation that may reveal all causes that affect the appropriateness of corporate governance principles, a further research is needed to clarify the key necessary revisions and refinements. The same applies to financial stability, lacking a widely spread definition, although the answers are swivelling around maintaining the well-functioning of the markets and minifying sharp and unwilling changes of financial indicators.

The battle with financial instability is far to be finished yet; there are threats that can be early observed and counter-attacked, but may be some that pass unobserved. Beside this, the functioning of some early warning systems is quite expensive and hard to implement, being needed trade-off decisions.

In the light of the last crisis, appeared the need for a set of immediately response guidelines in order to reduce its negative impact in the new befuddled framework, and diminish the potency of different groups of interest.

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